

IT 00-24

Tax Type: Income Tax

Issue: Job Training Expense Credit (Disallowed)

**STATE OF ILLINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
CHICAGO, ILLINOIS**

**THE DEPARTMENT OF REVENUE
OF THE STATE OF ILLINOIS**

v.

Illinois ABC Railroad Company,
Taxpayer

No. 98-IT-0000
FEIN: 00-0000000
Tax yrs.: 1994 & 1995

Charles E. McClellan
Administrative Law Judge

RECOMMENDATION FOR DECISION

Deborah H. Mayer for the Department of Revenue; Brian Browdy, Karen Black and Jordan Goodman of Horwood, Marcus & Berk, Chtd. for the taxpayer.

Synopsis:

This matter involves a protest to a Notice of Deficiency issued by the Department of Revenue to the taxpayer for the years 1994 and 1995.¹ It also involves denials of refund claims filed on amended returns for the years 1994 and 1995. The Notice of Deficiency and the amended returns involve training expense credit claims. The taxpayer reported a loss for 1989 and no net income for the years 1990 through 1993. For that reason, the company requested a carryover of the total amount of training expense credit reported on amended returns for 1989 through 1993 which it claimed on amended returns for 1994 and 1995.² A hearing was held on January 26, 2000, following which the parties filed briefs.

¹ Taxpayer files its income tax returns on a calendar year basis.

² At the hearing the taxpayer offered into evidence a second amended return for 1995 reporting a change in the apportionment formula for that year. Taxpayer Group Ex. No. 9., The Department did not object to the offer, so it was accepted into the record. However, neither party addressed the substance or the relevance of this amended return either at the hearing or in their briefs. Therefore, I give it no weight in my determination.

I recommend that the Notices of Deficiency and the denial of the claims on the amended returns be made final.

Findings of Fact:

1. On July 29, 1998, the Department of Revenue issued a Notice of Deficiency to Illinois ABC Railroad Company (“taxpayer”) for the years 1994 and 1995 proposing to assess additional income tax liabilities in the amount of \$377,037 and \$154,885, respectively. Dept. Ex. No. 1.
2. Taxpayer filed amended returns for the years 1989 through 1993 reporting training expense credit. Tr. pp. 6 – 7; Taxpayer Group Ex. Nos. 1 – 5.
3. Taxpayer filed amended returns for the years 1994 and 1995 claiming training expense credit and training expense credit carryover from the years 1989, a loss year, and 1990 through 1993, years for which taxpayer had no net income. Tr. pp. 14-15; Taxpayer Group Ex. Nos. 7 – 8.
4. The Department denied the claims for 1994 and 1995 by notices dated July 29, 1998. Dept. Group Ex. No. 2.
5. Taxpayer filed its protests to the Notice of Deficiency and the claim denials on September 23, 1998. Tr. p. 16.
6. Taxpayer is an interstate rail carrier. Dept. Ex. No. 5.
7. Taxpayer is regulated by the Federal Railroad Administration (“FRA”) as well as by other, primarily federal, authorities Tr. p. 71.
8. The oversight exercised by these agencies is primarily in the area of safety. Tr. p. 72.
9. Taxpayer files reports of accidents and injuries with the FRA and the FRA inspects taxpayer’s property and records for safety and compliance. *Id*

10. For approximately six or seven of the last ten years taxpayer has been awarded either the gold, silver or bronze E. H. Harriman award for safety which is awarded to class one railroads each year based on competition for the best safety record. Tr. p. 73.
11. Taxpayer conducts training for its employees in areas of management training, computer skills, safety and technical skills involved in operating a railroad. *Id.*
12. Taxpayer conducts classroom and seminar training sessions in the areas of engineer certification (mechanical), fall protection, hazardous materials operations, locomotive engineering, railroad police, safety shoe and the ICRR safety rule book, transportation rules, computer aided design, software programs Excel and Windows, first aid, welding, electrical training and numerous other disciplines. Tr. pp. 85-88; Taxpayer Ex. Nos. 12, 13.
13. Taxpayer also conducts apprenticeship training in conjunction with various trade unions and on-the-job training. Tr. pp. 112, 115.
14. Taxpayer engaged an outside consulting firm by the name of Advisors (“ADV”), JOHN DOE vice-president, to conduct a study to determine how much qualified training expense taxpayer incurred during the years 1989 through 1992. Tr. pp. 20, 24, 62.
15. MR. DOE’s firm did not prepare the amounts claimed as qualified training expense on the taxpayer’s amended returns for 1993 through 1995. Tr. pp. 62, 64.

Conclusions of Law:

This matter involves disallowed training expense credits, provided for under Section 201(j) of the Illinois Income Tax Act, 35 ILCS 5/201(j) (“TEC”), that taxpayer

claimed on its original income tax returns for the years 1994 and 1995 and the denial of claims for TEC made on amended income tax returns filed for those years. The claims include TEC reported on amended returns filed for the years 1989 through 1993. The taxpayer incurred a loss for the year 1989 and reported no taxable income for the years 1990 through 1993. The taxpayer then included the TEC from those years as a carry forward credit on amended returns filed for 1994 and 1995.

The issues to be decided were set forth in an order entered following a pre-trial conference as follows:

1. Whether the Department properly denied the training expense credits claimed by taxpayer on its original returns for the tax years ending December 31, 1994, and December 31, 1995.
2. Whether the Department properly denied taxpayer's refund claims for the tax years ending December 31, 1994, and December 31, 1995, on which taxpayer claimed additional training expense.

The section of the statute that sets forth the TEC provides as follows:

Beginning with tax years ending on or after December 31, 1986, a taxpayer shall be allowed a credit against the tax imposed by subsection (a) and (b) under this Section for all amounts paid or accrued, on behalf of all persons employed by the taxpayer in Illinois or Illinois residents employed outside of Illinois by a taxpayer, for educational or vocational training in semi-technical or technical fields or semi-skilled or skilled fields, which were deducted from gross income in the computation of taxable income.
35 ILCS 5/201(j).

The Department issued its regulation regarding the TEC effective March 31, 1995.

9 Ill. Reg. 5824. The regulation specifies that wages paid to employees in training or to employees while they are training other employees qualify for the TEC. 86 Ill. Admin.

Code § 100.2150.³ The regulation also requires “employers to maintain records sufficient to document that the training is eligible training” . . . and they must “document the amounts expended for eligible training expenses.” 86 Ill. Admin. Code § 100.2150(d)(3).

The Department's *prima facie* case is established by the introduction into evidence of copies of its records under the certificate of the Director. 35 ILCS 5/914, Balla v. Dept. of Revenue, 96 Ill. App.3d 293 (1st Dist. 1981). In this case the Department's *prima facie* case was established when it introduced the Notice of Deficiency and the refund claim denials under the certificate of the Director. A taxpayer's testimony alone will not overcome the Department's *prima facie* case. Central Furniture Mart v. Johnson, 157 Ill. App. 3d 907 (1st Dist. 1987). To overcome the Department's *prima facie* case the taxpayer must present consistent and probable evidence identified with its books and records. *Id.* For the reasons set forth below, I find that the taxpayer has failed to present evidence sufficient to overcome the Department's *prima facie* case.

³ The Department argues in its brief that the regulation is prospective only. However, in a memorandum dated September 28, 2000, I was informed that “. . . the Department is permitting the application of the TEC retroactively.” Therefore, this issue need not be addressed in this recommendation.

This case involves a credit that can be applied to reduce the taxpayer's Illinois income tax liability. It functions in the same manner as an exemption or a deduction, so the taxpayer's burden of proof must be the same as in the case of a claimed exemption. The taxpayer's burden in claiming an exemption has been described by the courts in the following terms:

A person claiming an exemption from taxation has the burden of proving clearly that he comes within the statutory exemption. Such exemptions are to be strictly construed, and doubts concerning the applicability of the exemptions will be resolved in favor of taxation. [Citations omitted.] Every presumption is against the intention to exempt property from taxation. [Citation omitted.]
United Airlines v. J. Thomas Johnson, Director of Revenue, 84 Ill.2d 446, 419 N.E.2d 899 (1981)

Taxpayer alleges that as a heavily regulated railroad engaged in interstate commerce it conducts numerous training programs for its employees. To calculate the amount of its training expense taxpayer hired the ADV firm. That firm did a study of the taxpayer's records for the years 1989 through 1992. Tr. p. 62. The results of that study were given to the taxpayer to prepare the refund claims. Taxpayer maintains that the consultant's study was sufficient to overcome the Department's *prima facie* case and to prove its claims for refund. At the hearing, taxpayer called two witnesses. The first witness was JOHN DOE the vice president of ADV ("DOE"). The second witness was MR. SMITH, the taxpayer's manager of training ("SMITH"). SMITH testified about the types of training taxpayer conducts for its employees and the records kept of such training. He did not testify about the dollar amount of training expenses that taxpayer incurred, however. DOE's testimony consisted of an explanation of the methodology used in the ADV study.

The Department argues that the ADV study was speculative and that it fails to support the taxpayer's claims.

SMITH has been employed with the taxpayer since May of 1976. Tr. p. 65. He started in the summers of 1976 and 1977 working as a track man and machine operator. *Id.* In 1978, after graduating from college, he became a clerk in taxpayer's accounting department and then a signal design engineer. *Id.* Later he was an apprentice electrician in the shop facility for three years. Tr. p. 66. Beginning in 1982 he was a claims agent for four years in central Illinois and then transferred

back to Anywhere as claims manager. *Id.* He became manager of casualty prevention in 1994 and began his current job in August of 1999. *Id.*

SMITH testified extensively as to the type of training taxpayer provides for its employees. The areas of training conducted include management skills, computer skills, safety, and the various technical skills involved in running a railroad. Tr. p. 73. Taxpayer has conducted classroom and seminar training in the areas of mechanical engineer certification, fall protection, hazardous materials operations, locomotive engineering, railroad policing, safety, transportation rules, computer aided design, first aid, welding and numerous other disciplines. Tr. pp. 73-100. Taxpayer is required to keep records of employee training for the Federal Railway Administration. Tr. p. 101; Taxpayer Group Ex. Nos. 12, 13. These records show the dates and types of training provided to employees, but they do not show any cost figures.

DOE testified extensively about his background and the manner in which he conducted his study to determine the amount of training expense taxpayer incurred that would qualify for the credit. With regard to his background, he testified that prior to joining ADV, where he has been employed for ten years and is currently a vice-president, he had several jobs all related to the state tax field. Tr. pp. 20-21. He was formerly the manager of state and local taxes for Playboy Enterprises and Quaker Oats Company. Tr. p. 20. He has been employed in the state and local tax area for twenty-nine years. Tr. p. 21. He did not testify about his educational background. With regard to ADV, he testified that it is a consulting company that provides its clients with tax savings ideas, audit defense services and research services. *Id.* ADV has clients throughout the country with about 50% of them being Illinois taxpayers. *Id.*

ADV conducted its study for taxpayer in two phases. Tr. p. 25. The first phase began in 1993. The second phase began in 1996. *Id.* The study covered the years 1989 through 1992. *Id.* ADV did not look at every one of taxpayer's documents that might support training expense credit. Tr. p. 26. Because of the large volume of documents, ADV used a random sample methodology. *Id.*

In the first phase of its study, ADV spoke with taxpayer personnel to determine which expense categories might contain qualified training expenses. Tr. p. 27. The expense categories and the percentage of qualified training expenses ADV determined to be contained in each are as follows:

<u>Expense category</u>	<u>Percentage deemed qualified</u>
Training expense	100
Computer software purchases	30
Meetings	50
Tuition	100
Membership dues and subscriptions	75
Outside or professional services	20
Travel and related expenses	10
Tr. pp. 30-32.	

The percentages ADV applied to these expense categories in phase 1, as shown above, were determined by ADV based on its experience with other clients and on what ADV deemed to be fair and reasonable. Tr. pp. 29-32. ADV then multiplied the expenses it deemed qualified by the payroll factor to determine the amount attributable to Illinois residents and to Illinois employees. Tr. pp. 32, 51, 52, 57. The payroll factor referred to by DOE in his testimony may be the payroll factor calculated by the taxpayer for the apportionment formula on its Illinois income tax return for each year, although the source of the payroll factor is not mentioned in his testimony.

In phase 2, ADV used random sampling in the categories to pick invoices to send, along with a questionnaire (Taxpayer Ex. No.10), to the person who approved the expense to try to determine if the expense was training related or not. Tr. pp. 34-35. The questionnaire did not explain or define what was meant by the word “training”. Tr. p. 51. ADV developed another questionnaire that it sent to the taxpayer with instructions to send it to a random number of managers and supervisors to find out how much time the employees reporting to them spent in training for the years 1992, 1993 and 1994. Tr. pp. 38-39, (Taxpayer Ex. No.11). The percentages used to determine the expenses in each expense category that ADV deemed qualified were adjusted based on the results of the sampling using the questionnaires. Tr. p. 45.

The results of ADV's study for the years 1989 through 1992 were given to the taxpayer to use in preparing its refund claims. Tr. pp. 61, 63. ADV did not do a similar study for the years 1993 through 1995. Tr. p. 62.

As noted above, A taxpayer's testimony alone will not overcome the Department's *prima facie* case. Central Furniture Mart v. Johnson, *supra*. To overcome the Department's *prima facie* case the taxpayer must present consistent and probable evidence identified with its books and records. *Id.* In this case, SMITH's testimony establishes that taxpayer conducts extensive training for its employees and did so during the years at issue. However, the only evidence in the record regarding the amount of training expense claimed is DOE's testimony regarding the ADV study. Neither the report of the ADV study, if there was one, or the ADV workpapers generated in conducting the study were offered into evidence.

Furthermore, although the Department did not object to DOE's testimony, there is no evidence in the record to indicate that he was competent to testify on the subject matter of his testimony. Whether an individual is an expert in specific areas of expertise is to be determined by the trier of fact in an exercise of its sound discretion. People v. Rozo, 303 Ill.App.3d 787, 708 N.E.2d 1229 (2nd Dist. 1999). DOE testified that the ADV study utilized random sampling methods. However, there is no evidence in the record that DOE is a qualified statistician or has any education, background or expertise in the fields of statistics or accounting. Thus, there is nothing in the record to suggest that DOE has expertise in the subject matter of his testimony regarding statistical methodology and financial account analysis.

Because DOE was not qualified as an expert in statistical methods or accounting, there is no basis in the record for determining that the ADV random sampling techniques produced valid and reliable statistical results. Furthermore, the percentages applied by ADV to the expense categories are purely speculative since they are based on ADV's experience with companies other than the taxpayer. Finally, ADV's use of the "payroll factor" to calculate the portion of expense for Illinois employees is also speculative. There is no basis in the record, other than speculation, that it relates in any way to the actual qualified training expenses incurred by the taxpayer. Because of the serious fundamental evidentiary defects enumerated above, I find the study to have no credibility.

In addition, the record is devoid of any consistent and probable evidence identified with taxpayer's books and records to support the training expense claimed to have been incurred in the years 1989 through 1992, the years included in the ADV study. The record is also devoid of any consistent and probable evidence identified with taxpayer's books and records to support the training expense claimed to have been incurred in the years 1993, 1994 and 1995, the years not included in the ADV study. Therefore, taxpayer has failed to overcome the Department's *prima facie* case.

For the reasons stated above, I recommend that the Notice of Deficiency and the denials of claim be made final.

ENTER: October 18, 2000

Administrative Law Judge